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No. 728

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

PATRICK C. GRANEY and THELMA GRANEY,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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OPINIONS BELOW

The decision of the United States Court of Appeals for the Fourth Circuit is reported at 377 F.2d 992. The decision of the District Court is reported as *Graney* v. *United States*, 258 F.Supp. 383 (D.C. S.D. W.Va. 1966).

JURISDICTIONAL STATEMENT

The decision of the Court of Appeals was entered June 2, 1967, and a timely petition for rehearing was denied on July 19, 1967. By an order entered July 27, 1967, the Court of Appeals stayed the mandate pending application in this Court for a writ of certiorari. This Court has jurisdiction over this matter by virtue of Sections 1254 and 2101 of Title 28, U.S.C.A.

QUESTIONS PRESENTED

1. Whether a taxpayer may treat a stock acquisition as a stock option taxable to him only as exercised where it is clear that the taxpayer enjoys all significant rights of ownership in the stock immediately upon execution of a so-called option agreement?

2. Whether in deciding Question No. 1 for Federal tax purposes the non-obligatory nature of an option contract as opposed to a contract of sale under state law should be given greater effect than the practical and substantive results of the agreement, which immediately confers all significant rights of stock ownership on the taxpayers?

3. Whether the Court of Appeals erred in sustaining the finding of the District Court that the taxpayers' date of acquisition and basis for stock in their hands must be calculated at the time of obtaining physical possession of stock certificates held in escrow rather than at the date of execution of an agreement which conferred upon them all significant rights of stock ownership?

4. Whether the decision of the Court of Appeals is in direct conflict with *MacDonald* v. *Commissioner*, 76 F.2d 513 (C.A. 2, 1935)?

5. Whether the decision of the Court of Appeals is in a way in conflict with decisions of this Court to the effect that in tax cases the form of a transaction must not be favored over its substance.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

Sec. 61. Gross Income Defined.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income

from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * * *

(26 U.S.C. 1964 ed., Sec. 61.)

Sec. 1222. Other Terms Relating to Capital Gains and Losses.

For purposes of this subtitle—

* * * *

(3) *Long-Term Capital Gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

* * * *

(26 U.S.C. 1964 ed., Sec. 1222.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.61-2 *Compensation for services, including fees, commissions, and similar terms.*

(d) *Compensation paid other than in cash*—* * *

(2) *Property transferred to employee;* * * *. Except as otherwise provided in section 421 and the regulations thereunder (relating to employee stock options), if property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property in-

creased by the amount of such difference included in gross income. * * *

* * * * *

(26 C.F.R., Sec. 1-61-2.)

STATEMENT OF THE CASE

Patrick C. Graney (taxpayer)[1] was President and a member of the Board of Directors of Gulf Mining Company, which, on June 30, 1953, acquired by merger West Gulf Coal Company, of which taxpayer had also been a director. By way of compensation for past and future services and as inducement to him to accept the presidency of the merged corporation, the corporation entered into an agreement with the taxpayer dated May 1, 1953, effective June 1, 1953, granting him certain stock rights (App. 24).[2] The tax effect to be given taxpayer's rights under this contract are the subject of this litigation.

The contract (Plaintiff's Ex. # 6, reproduced in full at p. 23 of Appellee's Appendix below) was titled a stock option agreement and granted taxpayer the right to buy 500 shares in the new corporation for $25.00 per share payable at any time in whole or in part within five years commencing June 1, 1953. Paragraph 5 of the contract, however, provided that immediately upon execution of the agreement, the taxpayer, his successors and assigns, would have the right to vote the stock, to exercise all stockholder's rights with respect thereto, and to receive all benefits therefrom. The taxpayer did, in fact, vote the stock on several occasions, and, though no dividends were paid during the relevant period, the testimony of the other directors was that he would have had the right

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[1] Thelma Graney is involved only because joint returns were filed for the years in question.

[2] Unless otherwise noted, references are to the Appellant's Appendix printed for the Court of Appeals.

to receive such dividends if declared (App. 24-26, 46, 49). The Board of Directors of the merged corporation ratified the agreement by a resolution in which they set forth the details of the form of the agreement, and on July 1, 1953, 500 shares of the common stock of the merged corporation were issued in the name of the taxpayer (App. 24). The stock certificates were delivered to the taxpayer who in turn placed them in escrow with a bank on the understanding that the bank would redeliver possession of them to the taxpayer when and as the purchase price was paid by him (App. 24 et seq.).

At the time of the execution of the agreement the stock was worth approximately $75.00 per share—i.e. approximately $50.00 per share more than the price which the taxpayer had to pay (App. 25-26, 45-46, 52-53). In late 1953, the taxpayer paid $2,500.00 and received 100 shares out of escrow. Again in 1954 and 1955, he followed a similar pattern, taking an additional 100 shares down from escrow in each year, and in 1956 he made a final payment of $5,000.00 to obtain the last 200 shares. (App. 27-28). On the advice of E. C. Connelly, Certified Public Account, deceased at the time of the trial, taxpayer treated the acquisition of the stock from escrow in each of these years as additional compensation, the amount being calculated on the difference between the bargain purchase price and the fair market value of the stock. Mr. Connelly never saw the agreement of June 1, 1953 but determined its effect as a result of telephone conversations with the taxpayer (App. 36). The same type of tax treatment of the contract was adopted by the corporation on its returns for each of the years in question.

In late 1955 negotiations were initiated for the sale of the stock and on January 4, 1956 an option was granted to Winding Gulf Coals, Inc. to purchase the stock at $200.00 per share less a $10.00 per share sales discount.

Thereafter, Winding Gulf exercised its option and on February 23, 1956 the transaction was consummated with the taxpayer receiving $190.00 per share for his 500 shares (App. 33-34). Using as a basis the original fair market value of the stock in his hands—i.e. $75.00—the taxpayer reported the proceeds of the sale as long-term capital gain.

Taxpayer's treatment of this transaction assumed that all of the stock was effectively acquired on June 1, 1953 with a basis of $75.00 per share. The Government takes the position that the taxpayer acquired 100 shares of the Gulf stock in December 1955 and 200 shares in February 1956, when he took the shares down from escrow. The Government also contends that the value of the shares at those times was $190.00 per share and that additional compensation taxable as ordinary income was received at that time. Accordingly, the Government assessed deficiencies for the years 1955 and 1956 together with a 5% negligence penalty. The taxpayer paid the deficiencies, penalties, and interest aggregating $16,347.31 and thereafter filed timely refund claims for the years 1955 and 1956 which were denied by the Commissioner of Internal Revenue on June 3, 1960. Thereafter, suit for refund was timely filed pursuant to Sections 1346(a)(1) and 1402(a) of Title 28, U.S.C.A., which concluded with a rejection of the refund claims by the District Court, except that the negligence penalty was eliminated.

SUMMARY OF ARGUMENT

The taxpayer contends that the sweep of ownership rights granted by the agreement of June 1, 1953 was sufficient to constitute him the owner of the stock for tax purposes as of that date. The formal facts that the agreement was titled an option agreement and that payment of the purchase price was a condition for physical delivery of the stock certificates are far outweighed by

the substantive rights to vote the stock, to receive dividends, and to sell the stock, all of which rights accrued to the taxpayer in 1953. By deciding to the contrary, the courts below erroneously elevate form over substance and depart from decisions of other circuit courts as well as of this Court. The taxpayers have at all times expressed a willingness to consent to a proper assessment for the year 1953 if the refund claims are allowed.

ARGUMENT

I. The Decisions Below Permit Form to Override Substance Contrary to Decisions of This Court.

Sustained without reservation by the Circuit Court in a per curiam opinion, the District Court found that the June 1, 1953 contract was an option agreement and must be taxed as such. This conclusion was based entirely on a finding that the agreement did not obligate the taxpayer to buy the stock. Under applicable West Virginia law, a purchase contract must irrevocably bind both parties, one to sell and one to buy; since this agreement did not, it was concluded that it must be treated as an option agreement for tax purposes. The decision of the District Court, in its own words, may be summarized:

> * * * A study of the agreement here in question indicates quite clearly that there was no obligation upon the taxpayer to purchase any of the stock. * * *[3]

Petitioner contends that to decide this case on the basis of the technicalities of state contract law and a literal construction of the form of the contract is a total departure from standards laid down by this Court in numerous tax cases. The rule that form must be subordinated to substance in tax matters can be traced to the

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[3] *Graney* v. *United States*, 258 F.Supp. 383, 387 (D.C. S.D. W.Va. 1966).

decision of this Court in *Eisner* v. *Macomber*, 252 U.S. 189, 206, where the following language occurs:

> In order, therefore, that the clauses cited from article 1 of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not "income," as the term is there used; and to apply the distinction, as cases arise, *according to truth and substance, without regard to form.* * * * [Emphasis supplied.]

Again, in *Weiss* v. *Stearn*, 265 U.S. 242, 254, the Court repeated the proposition in the following terms:

> * * * Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the 16th Amendment, and income laws enacted thereunder, we must regard matters of substance, and not mere form.

The same maxim is stressed in *Gregory* v. *Helvering*, 293 U.S. 465; *Helvering* v. *Tex-Penn Oil Company*, 300 U.S. 481; and *Helvering* v. *F. & R. Lazarus and Company*, 308 U.S. 252. In *Commissioner* v. *Court Holding Company*, 324 U.S. 331, 334, this Court said again:

> * * * The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. * * *

Thus, it can be seen that form must not be revered over substance in cases of this kind, nor should technicalities of title be determinative. At the same time, the Court has established the essential touchstone for which the lower courts here *should* have looked as follows:

> We cannot too often reiterate that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss* v. *Bowers*, 281 U.S. 376, 378, 74 L.ed. 916, 917, 50 S.Ct. 336. And it makes no difference that such "command" may be exercised through specific retention of legal title or the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency. * * * [*Griffiths* v. *Helvering*, 308 U.S. 355, 357-358.]

From this language it is clear that in Federal tax matters the appropriate stress must be not upon *obligation* but upon *benefit*. From June 1, 1953 on, the taxpayer here enjoyed all the benefits of stock ownership, benefits on which he should be taxed in full in 1953. From 1953 on he could and did vote the stock. Had there been dividends declared, it is freely conceded by all concerned that he would have been entitled to receive them. He had the right to transfer and sell his rights under the agreement. In short, all significant benefits accrued to him at the time of the agreement, and the mere convenient mechanism of payment should not change the tax result. The courts below recognized these facts,[4] but placed total stress on the lack of an obligation to buy the stock, an absolute departure from principles stated by this Court.

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[4] The District Court agreed that "the option agreement by its terms, vested in the taxpayer a number of rights and privileges which ordinarily would be associated with ownership of stock."

II. The Decisions Below Are Contrary to Decisions of Other Courts of Appeals on the Same Subject.

A. The decisions below are contrary to the reasoning if not the result of decisions of other courts of appeals.

As indicated above, the decisions below turn on the concept of obligation to reach the result that the contract was taxable as an option contract. Other courts of appeals have reached a similar result on the facts before them, but an examination of these decisions reveals that absence of obligation was not an element in the result, but rather the fact that there was no transmission of the benefits of ownership. In other words, though there are cases apparently decided against the taxpayer on essentially the issue in this case, the decision against the taxpayer in those cases was made precisely because there was absent the most important element of this case—the immediate transmission of all significant benefits of stock ownership. In not one instance did the taxpayer in these other cases become endowed with any rights whatsoever upon execution of the agreement. It is submitted that these decisions, apparently contrary to the taxpayer's position here, would have gone precisely the other way on the instant facts, judging from the standard applied in those cases.

For example, in *United States Industrial Alcohol Co.* v. *Helvering*, 137 F.2d 511, 516, the Second Circuit stated, "The right to possession and title were all to depend upon the payment of the first installment." Similarly, in *Stiver* v. *Commissioner*, 90 F.2d 505, 508 (C.A. 8, 1937), it was said, "There was * * * no transfer of the benefits or burdens of ownership." In the instant case, on the other hand, the point of contention arises precisely because without regard to his *obligation*, there was transferred to this taxpayer all significant *benefits* of possession and

ownership at the time of the execution of the option agreement. It is true that his possession of the stock certificates was limited by the escrow, but this should not be controlling as the following shows:

> Whether a contract is one of sale or one to sell depends very largely upon the intention of the parties. If they intend a present transfer of title it is a contract of sale; otherwise, it is a contract to sell. As between contracting parties, if the statute of frauds or the rights of third persons are not involved, *neither immediate delivery of the chattels nor payment of the purchase price is essential to effect a present sale with immediate transfer of title. Hatch* v. *Oil Co.*, 100 U.S. 124, 25 L.Ed. 554; *Stewart* v. *Commissioner* (C.C.A.) 49 F.(2d) 987; *Calcara* v. *United States* (C.C.A.) 53 F.(2d) 767; *McElwee* v. *Metropolitan Lumber Co.* (C.C.A.) 69 F. 302; *Jones* v. *Commercial Investment Trust*, 64 Utah, 151, 228 P. 896; *Kneeland* v. *Renner*, 2 Kan. App. 451, 43 P. 95; *Rail* v. *Little Falls Lumber Co.*, 47 Minn. 422, 50 N.W. 471. [*United States* v. *Amalgamated Sugar Co.*, 72 F.2d 755, 758. Emphasis supplied.]

From this it is clear that physical possession of the stock inhibited by the escrow, is of no consequence in determining whether or not a sale had taken place, and this fact should not have deterred the Court below from finding that title and all significant rights of possession vested in the taxpayers in 1953.

The proper way of analyzing the instant transaction was suggested in *Moore* v. *Commissioner*, 124 F.2d 991 (C.A. 7, 1941), where the Court adopted the view that a transaction of this kind was in the nature of a conditional sale with the payment of the purchase price a condition subsequent. Interestingly, the Court in the *Moore* case took this view even though the right to vote

the stock in that instance remained in the seller during the period of the agreement. A similar view was adopted in *Schneider* v. *Duffy*, 43 F.2d 642, 646, where the Court said:

> The broad sweep of the rights transferred to Schneider herein makes it very evident that the only thing withheld from his acquirement of complete domination in the premises was the physical possession of the evidence of his ownership, viz. the stock certificates, and the conditions attending such withholding and the later transfer thereof, imposed as they were by the assigning company, constituted conditions subsequent to the inception and execution of the contract, and the vesting of ownership in Mr. Schneider serving merely as collateral security to the company for Schneider's faithful performance of his obligations, and conditions which could be met only by the passage of time.

On this point, see also *Chaplin* v. *Commissioner*, 136 F.2d 298.

In summary, it seems fair to state that the result in each of the foregoing decisions was reached after an analysis of the extent of the beneficial rights conferred upon the taxpayer, not by adherence to form. If such an approach had been used here it is submitted a contrary result would have been reached.

B. *The decisions below are in direct conflict in both reasoning and result with* MacDonald v. Commissioner, *76 F.2d 513.*

In the *MacDonald* case, the Second Circuit was faced with the converse of the instant situation, since the issue to be decided was whether the taxpayer (MacDonald) had effectively *sold* his stock. He had entered into an agreement, the results of which the court describes as follows:

> The contracts of sale, read as a whole, disclose that the stock was to remain in the petitioner's name, delivery to await full performance of petitioner's own contract of purchase; that he was entitled to all the dividends of the stock "sold" by him; that he was to have the voting rights and the right to execute all legal documents in connection with the stock. He was given unlimited discretion to sell the stock to whomsoever, whenever, and at such terms as he chose; in the event of a sale by him, he agreed to pay the "purchaser" the amount of money they had advanced to him with interest, or a proportionate percentage of the proceeds of sale, whichever amount was the greater; * * * [*MacDonald* v. *Commissioner*, 76 F.2d 513, 514.]

Faced with these facts the Court determined that because of the extent of his retained rights, the stock remained his property notwithstanding the execution of a sales contract. As the Court put it:

> * * * The most important rights of the preferred stock were retained by this petitioner, and *where such rights are found there is where the title resides* * * * [76 F.2d at p. 514; Emphasis supplied.]

In making its decision, the Second Circuit was unimpressed by the argument that MacDonald could not sell the stock until he had paid the purchase price to obtain it. The Court found that it was always in his power to make payment at any time in order to carry out a sale, and the same considerations apply here. Petitioner submits that there is no difference whatever between the rights retained by MacDonald and those conferred upon petitioner in 1953. It is respectfully submitted that the result and reasoning below in this case are in direct conflict with the *MacDonald* decision, and require review by this Court.

III. The Issue Herein Is of Considerable Public Importance.

Except for physical possession of the stock certificates, the effect of which is discussed, *supra*, there was not one right of stock ownership not conferred upon this taxpayer as of June 1, 1953. Moreover, under the agreement, his rights were freely transferable, both *inter vivos* and at death. According to the views of the courts below, however, no gain or loss would have been realized on the transfer of these rights *inter vivos*, since they were valueless, and they would have passed free of estate tax for the same reason.

If this view is correct, it is fortuitous for the Government that the option period in this case was only five years. Adopting the view of the courts below, the taxpayer might have held all the important rights to this stock for 50 or perhaps 75 years without paying tax on the benefits of such stock ownership, provided he was careful not to pay the purchase price and thereby obtain possession of the stock certificates during that period.

In petitioner's submission, to sustain such a view is, in the words of Chief Judge Staley, to open "the door wide for individuals to avoid tax consequences by artifices * * *. This result is an invitation to tax evasion."[5] The orderly administration of the taxing statutes requires that this Court intervene in this case to assure for future taxpayers that they can be guided in reporting their income by the substantive benefits which they receive rather than the technical formalities of the instruments involved in the transaction. Surely, the result should not be determined by the fact that in this particular case it is more beneficial to the revenue to insist on the form of the transaction,[6] while on the whole adherence to such a

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[5] *Commissioner* v. *Danielson*, 378 F.2d 771, 782, cert. den. Mon., October 9, 1967.

[6] In this regard, there can be no doubt that if the stock had depreciated after 1953, the positions of the parties would likely be totally reversed.

theory could result in great tax avoidance for those who take advantage of form over substance as is here advocated by the Government.

CONCLUSION

Wherefore, it is respectfully submitted that certiorari should be granted.

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